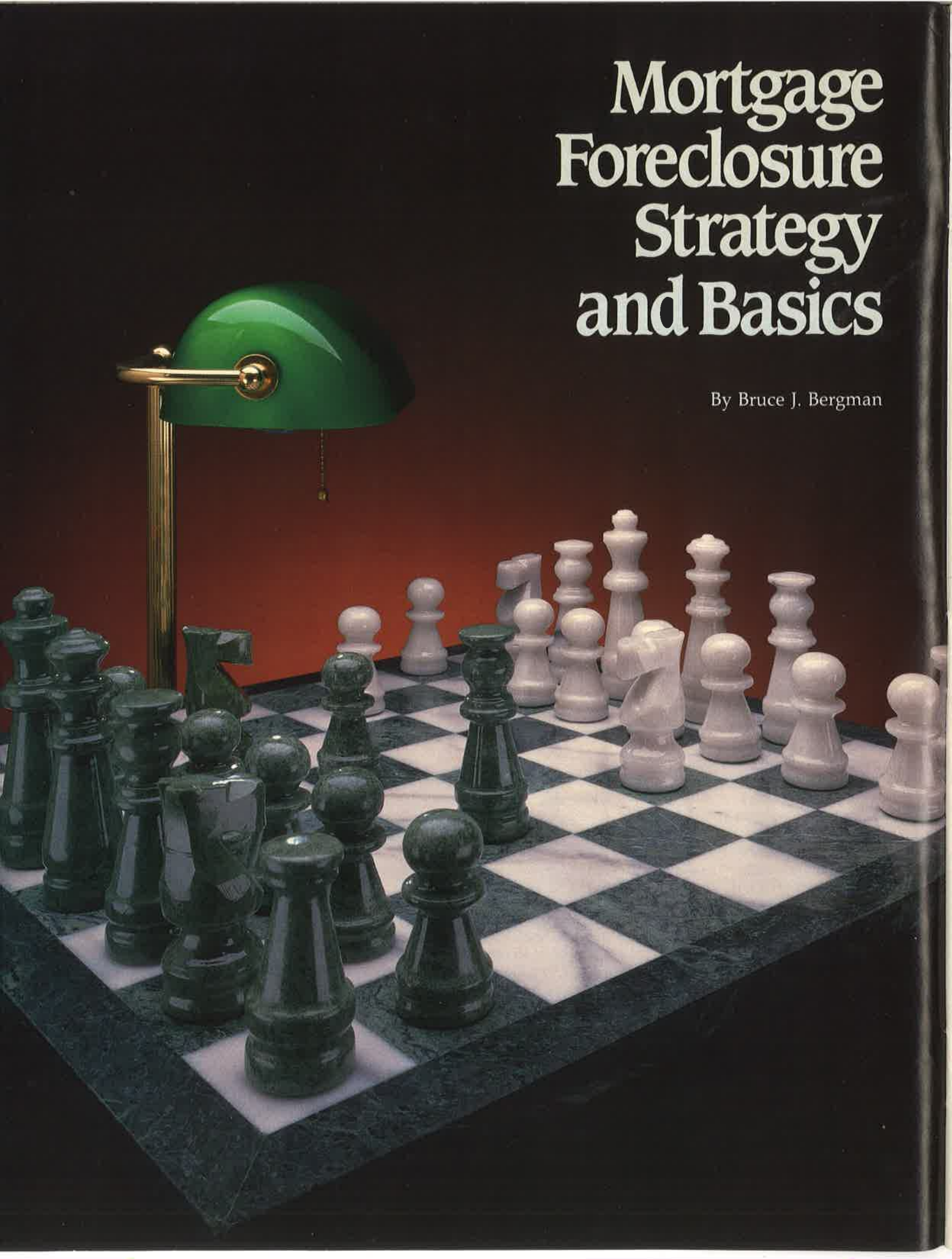
Mortgage Foreclosure Strategy and Basics

By Bruce J. Bergman



With the possible exception of the 27 states which may routinely employ non-judicial foreclosure (Alabama, Alaska, Arizona, California, District of Columbia, Georgia, Idaho, Maryland, Massachusetts, Michigan, Minnesota, Mississippi, Missouri, Montana, Nebraska, Nevada, New Hampshire, Oregon, Rhode Island, South Dakota, Tennessee, Texas, Utah, Virginia, Washington, West Virginia and Wyoming), mortgage foreclosure tends to be a highly technical calling, generally considered to be a province reserved solely for specialists.

While to a significant extent that view is correct, a lawyer who seldom prosecutes foreclosures will still on occasion encounter a client with a mortgage in default—or one imminently close to that condition. Although a non-specialist may be reluctant to undertake a foreclosure—especially a large one—nevertheless, a familiarity with the basic obligations of the parties and the attendant strategies can lead to perceptive advice and considerable success. It is worthwhile to emphasize in any event that prosecution of foreclosures will always be dependent to some significant extent upon practice in the particular jurisdiction. Consequently, statutes and rules should always be consulted with care.

Obtaining Leverage Through Acceleration

Any properly drawn mortgage will contain a clause giving an option to the mortgagee to declare due the entire balance of principal and interest on the loan upon the happening of certain events. The most obvious and common default triggering this right is the failure of the mortgagor to make the payments. There are, of course, other defaults, such as failure to keep the premises insured or neglect to pay taxes, among others. But these are less frequently encountered and are generally treated by courts as less severe defaults, raising legal issues beyond the scope of this article.

When a mortgagor does not pay, the mortgagee has two basic choices. At the expiration of the grace period (usually 15 days, but it can be more or less), mortgagee can begin collection procedures or accelerate. While there are very good reasons why acceleration might be in order at this point, many mortgagees follow the usual custom of giving the mortgagor further opportunities to submit the past due payments. An installment one month late usually precipitates one type of letter. Two months' worth of arrears elicits a sterner warning. At the end of three months, most mortgagees will, and should, accelerate.

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This acceleration—the declaring of the entire balance due—is the essential method of controlling the collection-foreclosure process. Acceleration is critical because it grants the mortgagee enormous leverage and allows for dealing from a position of strength, on the mortgagee's terms and at the mortgagee's pace. To appreciate the suggested aphorism, observe this point. Until the mortgagee accelerates, the mortgagor is free to pay arrears, at his/her leisure and convenience. The mortgagee *must* accept a valid tender of those arrears, even if months or even years late. On the other hand, once there has been acceleration, it is generally the case that arrears can be rejected without any reason. The mortgagee may then insist—if it chooses—upon full payment of the *entire* mortgage.

Note, however, that some forms of mortgage, notably the Federal National Mortgage Association ("FNMA") version in wide use by institutional lenders throughout the United States, compel acceptance of arrears even after acceleration, so long as prior to issuance of the judgment of foreclosure and sale. Accordingly, whenever this article states that arrears need not be accepted after acceleration, it presupposes that neither the FNMA form nor mortgages containing similar language have been employed.

Of course, a mortgagee may not wish to extract that full payment. But having the power to do so has a considerable salutary effect on the future of that loan. In addition to establishing control over the situation, there are two major reasons explaining why the acceleration is so vital.

First, suppose the not uncommon circumstance of the chronic defaulter. Month after month, year after year, payments have been pursued and the mortgagee no longer wishes to incur the time, expense and problem this mortgagor represents. But the mortgagor's problems attach to the mortgagee for the life of the loan—in the absence of acceleration. As noted, before acceleration, the mortgagor is free to tender arrears at any time and the mortgagee is constrained to accept, even if the preference is to reject. Upon acceleration, however, the mortgagee need not accept those arrears and may instead require full satisfaction of the mortgage.

Second, suppose this particular loan is at an interest rate well below the current market return. No matter how tardy the mortgagor has been, until valid acceleration, the loan will continue to yield that deficient rate of interest. Once acceleration is accomplished, the mortgagee is free to foreclose—thus eliminating the unwanted loan—or, alternately, to insist that the mortgagor enter into a modification of the mortgage whereby the interest rate is increased to an appropriate percentage rate. The mortgagor may object but does not have a choice. If the mortgagor does not agree, the consequence is foreclosure or the obligation to pay the loan in full. Again, *there* is the leverage.

Still another corollary benefit to the concept of acceleration is to be found. Assume the unfortunate but not uncommon situation where the mortgage documents neglect to provide recompense for legal fees. In most jurisdictions, absent an attorney's fee clause in the mortgage, no matter how extensive and expensive collection and foreclosure efforts have been, the mortgagee cannot compel the mortgagor to pay for such efforts. Similarly, if the foreclosure proceeds to a sale, the legal bill must

be paid by the mortgagee—at least to the extent agreed to by lawyer and client. But after acceleration (assuming the mortgagee desires to countenance reinstatement), the mortgagee may, as a condition of that reinstatement, correctly demand reimbursement for legal fees incurred. The mortgagor may consider this unfair, but the mortgagee is simply not obligated to reinstate after acceleration.

For a variety of reasons, some mortgagors either cannot or will not make their payments or otherwise meet their obligations under the mortgage. There must come a time when a mortgagee, perhaps as advised by astute counsel, recognizes that the promises or attempts to comply with the mortgage are either insincere or that the mortgagor's ability to honor the obligations just does not exist. When that time arrives, collection efforts will be fruitless. Then it is time to accelerate. When acceleration is achieved, the mortgagor is much more likely to realize that the mortgagee is resolute in its stance. A demonstration of strength is a more effective way to compel a conclusion than mere gracious equivocating.

Carrying the concept a step further, all during the collection and cajoling process, interest, arrears, taxes and late charges (if the mortgage provides for the latter) are continuing to accrue. Meanwhile, the property itself may be deteriorating. The confluence of mounting costs and diminishing value create a distinct possibility that the security for the loan is in jeopardy. The passage of time may thus become the mortgagee's enemy. Until acceleration, there is no progress. Upon acceleration, however, the foreclosure can proceed.

How to Accelerate

How the mortgagee efficaciously exercises the valuable option of acceleration is of critical importance. Some mortgage acceleration clauses *are* self-executing, although these are unusual and clearly the exception. Rather, these clauses generally provide that upon the happening of some occurrence—an act of commission or omission by the mortgagor—the mortgagee has the right or option to declare that the entire sum secured by the mortgage is immediately due and payable. The demonstration of that election is something which must be manifested.

There are two ways to accomplish an election. The mortgagee may choose to send a letter setting forth the acceleration. The other choice is to accelerate by the actual filing of the summons, complaint and notice of pendency with the court. This assumes that practice in a given state allows filing of papers at the inception of the action and that case law confirms the filing to be an act of acceleration. This may be subject to variation in some jurisdictions. While either method therefore generally suffices, it is obviously easier and faster to use the correspondence approach.

If the letter route is chosen, two further points necessitate attention. Especially when the mortgagee is a sophisticated institutional lender, it can assume the correspondence task itself. This would be the most rapid way to obtain the leverage provided by acceleration. Alternatively, the mortgagee's counsel can prepare the letter. The first way is preferable, so long as the letter is properly drafted. The time involved in conveying the file to the lawyer militates in favor of recommending that the mortgagee assume the correspondence duties.

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Regardless of who transmits the correspondence, the precise tenor of its contents is important. It must be an absolutely clear, unequivocal declaration that the mortgagee has chosen to demand due the entire balance of principal and interest. Advising the mortgagor to see a lawyer, asserting merely that arrears will no longer be accepted, or similar tenuous verbiage will be insufficient. Likewise, a demand for payment of arrears within some period of time, failing which the mortgagee intends to call the balance or institute foreclosure, is only a statement of future intention and will not serve as an acceleration.

Avoiding Waiver

Although case law can vary from state to state, any mortgagee who has chosen to accelerate must be cognizant of the pitfalls of waiving that acceleration. Generally, any act inconsistent with the desire to accelerate can be deemed a waiver.

Consequently, accepting arrears after acceleration vitiates the ability to foreclose, as does acceptance of a partial payment. Receiving a check and holding it—even without negotiation—for a period of time might be considered as incongruous with acceleration and could be condemned as a waiver by a court. Therefore, a mortgagee who wishes to maintain the foreclosure must be advised to promptly reject any payment which is less than the *full* amount due on the entire mortgage.

Default and Notice

Having established the value of acceleration, there are preliminary issues to be evaluated by counsel before acceleration can properly be addressed. The most common variety of mortgage default is failure to timely remit a payment. Precisely when that payment becomes overdue is an essential point for analysis.

Most mortgages require payments of both (or either) principal and interest periodically—most often monthly, although quarterly or even less frequent payments are certainly possible. Regardless of the date payment is due, however, mortgages almost invariably provide a grace period during which the mortgagor is free to submit a payment without consequence. Fifteen days is typical but the period could be more or less. Until the grace period has expired, the mortgagee is not empowered to accelerate or foreclose because no default yet exists.

While grace periods do not usually apply to other defaults under the mortgage, notice and cure periods may be relevant. Significantly, and notwithstanding what may be usual or customary, any mortgage could contain unexpected provisions. Accordingly, counsel must always review the particular documents at issue to determine what is the precise agreement of the parties. Perhaps the most pervasive of these periods ap-

plies to failure to pay real property taxes. A majority of mortgages will condition acceleration for this variety of default upon notice (traditionally 30 days) together with an opportunity to cure during that period. Until the time to remedy the default has passed, there is no default sufficient to underwrite acceleration.

It should be determined whether notice is a condition precedent to acceleration. In a very general sense only, notice of default or notice that acceleration is to ensue is *not* necessary. Whether that is so in a particular case will depend upon the nature of the breach and the manner in which the mortgage documents treat the violation.

Mortgages tend to be derived from local or national forms developed over many years, which suggests that generalities can have valid application. But any form is subject to negotiation and the exigencies of the moment when the documents were signed.

Turning again to the most common default—failure to submit a mortgage payment—the statutory form of mortgage in New York, for example, does *not* require any notice as a prerequisite to acceleration. Once the grace period has passed, the mortgagee may immediately declare due the entire balance of principal and interest without prior warning of any kind. This is generally true throughout the country. Significantly, however, this same form of mortgage mandates 30 days notice for failure to pay real property taxes. Demands are also preconditions when a variety of other defaults occur. Clearly, then, the document at issue must be analyzed.

In common use throughout the 50 states is the FNMA form of mortgage, as well as derivations of that document. That mortgage requires notice of, and a 30 day period to cure, *any* default. Thus, the mortgagee who attempts to accelerate or foreclose without having first meticulously examined the terms of the mortgage contract risks at least ineffectual action together with unnecessary expense, delay and consternation.

Settlement Strategy

Assuming that the carefully conceived acceleration letter was timely transmitted after any applicable grace or notice periods, the mortgagor may not yet have awakened to the seriousness of the situation. If then a foreclosure action must be instituted, the likelihood is that the mortgagor will eventually attempt to do *something* to avoid loss of the property.

That "something" can take a number of forms. Perhaps the most frequent action is a promise to send a check sufficient to cover all arrears and costs. If the mortgagee desires to allow reinstatement—although there is usually no obligation to do so—the issue to be faced is whether to halt the foreclosure while awaiting the payment.

The suggested response is in the negative. Bearing in mind that foreclosure actions are ritualistic, with completion of each stage being a prerequisite to the next step, considerable delay can result from holding the action in place solely on the basis of a promise. For example, procedure might be service of summons and complaint, order of reference to compute (or hearing or inquest by the court to compute), judgment of foreclosure and sale, advertising notice of sale or auction sale. Experienced foreclosure practitioners will confirm that defaulting borrowers rarely send the payment when pledged. Whether the reason is lack of candor or inability is not the point. Mortgagors in default are in a perilous position and erratic conduct on their part is not unexpected. Stopping the action upon the usually vain contemplation that reinstatement is momentarily forthcoming is not the best strategy.

Rather, the mortgagor should be advised that the mortgagee is empowered to reach the next plateau in the case on a date certain. If payment is received before that time, the mortgagee will refrain from proceeding further. However, if the money does not arrive, the mortgagee will go on to the next step and the mortgagor will be responsible for the additional legal fee incurred.

This serves a dual purpose. It puts pressure on the mortgagor to honor the promise or suffer additional cost for failure to do so—assuming the mortgagee will ever again countenance reinstatement. At the same time, the action moves that much further towards a conclusion without the delay elicited by false promises. The mortgagee loses nothing and

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concurrently demonstrates the firmness of its position.

If the mortgagor's arrears are too large to pay at one time, settlement entreaties could be couched in a request for reinstatement amounts to be paid over time. If the concept is acceptable to the mortgagee, there is danger in accepting payments of less than the full arrears lest waiver of acceleration result. Accordingly, this settlement must be accomplished by a stipulation clearly setting forth that the periodic payments do not constitute a waiver.

While all the nuances of a well crafted stipulation are too lengthy for this article, there are a few highlights to be mentioned. If the mortgagor ultimately defaults on the stipulation, he or she could always attempt to rely on any answer which has already been interposed or introduce defenses which have been retained in reserve. Consequently, an essential element of any reinstatement stipulation is an acknowledgment by the mortgagor of proper service of process, withdrawal of any answer currently before the court and a waiver of any and all defenses to the foreclosure. Moreover, the stipulation should specifically provide that, rather than the foreclosure being discontinued during the term of the stipulation, it is being held in abeyance, with the mortgagee authorized to continue the foreclosure from the point to which it proceeded upon any default by the mortgagor.

Deed in Lieu of Foreclosure

A final standard settlement concept is the offering by the mortgagor to the mortgagee of a deed in lieu of foreclosure. This may have advantages to both parties. It avoids the time, trauma and expense of foreclosure and greatly reduces the possibility of physical deterioration of the mortgaged premises. From the mortgagor's perspective, it ends the

case and means he or she will have no liability for any deficiency.

While from the mortgagee's viewpoint the action also comes to a rapid conclusion, the mortgagee cannot later seek a deficiency—certainly a factor to be considered. Moreover, the mortgagee does not benefit from extinguishment of all junior liens and encumbrances on the property which would have occurred had the foreclosure gone to its ultimate end. Hence, the mortgagee must carefully examine the status of the title and make a business decision as to whether it wishes to own the property burdened by the extant encumbrances junior to its mortgage.

Finally, if there is equity in the property above the mortgage debt, the conveyance of the deed could run afoul of the Bankruptcy Act and could be susceptible to avoidance as a preference. If title insurance is prevalent in the jurisdiction where the deed in lieu is being considered, the mortgagee's counsel should seriously consider recommending such insurance.

The Receiver

Notwithstanding that mortgagee's counsel is armed with all the techiques to solve the early problems in a foreclosure, a mortgagor could choose nevertheless to litigate. This situation can then be exacerbated by physical deterioration of the property, resulting in diminution of the mortgage security to the point where the mortgagee will sustain a loss.

A permutation of this idea relates to a commercial property—for example, a shopping center or an apartment building. The mortgagor subjected to a foreclosure, knowing the case will ultimately be lost, embarks on a course of action to "bleed" the property. He or she collects all the rents and profits but neglects repairs, payment of taxes and insurance and every other possible cost. This turns a handsome profit for the mortgagor and funds a protracted defense to the foreclosure. Under these circumstances, one need not expound at length upon the expected deteriorated value of the mortgaged property at the conclusion of the foreclosure.

In response to this very real dilemma, the mortgagee's lawyer has a great asset in the ability to appoint a receiver. In a foreclosure action, when the lender believes that the property may decline in value during the progress of the case or that the mortgagor or some occupant may allow the property to depreciate or be vandalized, the appointment of a receiver is available to preserve the premises for the benefit of the mortgagee. Although most often sought for income producing properties and multiple residential dwellings, receivers can be obtained for one and two family homes if the property is in danger or if the litigation is expected to be lengthy.

The receiver stands in the shoes of the owner. Once appointed and qualified, the receiver has the right to collect all rent due or to become due arising out of the premises. The receiver collects the income, maintains insurance, pays taxes and makes repairs. The property is, therefore, preserved. In addition, any excess income is applied in reduction of the mortgage and consequently a two-fold purpose is served. Still further, the mortgagor's interest in delaying the foreclosure is greatly diminished, if not entirely eliminated.

Conclusion

While this article does not suggest that any foreclosure action can be undertaken without trepidation, it does urge that familiarity with the basics can enable even non-expert counsel to do a great service to almost any mortgagee.

The procedures are rather straightforward. Read the documents with precision to ascertain the proper remedy for the specific default. If acceleration can issue without notice, advise the client as to the advantages of prompt attention to that valuable option. If there are conditions precedent to acceleration, such as notice and a period to cure, comply meticulously and punctiliously.

If nevertheless foreclosure ensues, be aware of helpful settlement techniques and, if the mortgagor opts to be litigious, apprise the client of the availability of a receiver as an aid to the litigation.

It helps to be an expert, but you don't have to be.

Bruce J. Bergman is a partner in the law firm of Roach & Bergman, Garden City, New York.